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Mr. Bruce Burcat
Public Service Commission
861 Silver Lake Blvd, Suite 100
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Dear Bruce:

Thanks for taking the time to speak with me last week about issues surrounding the deregulation of electricity.

As you know, I have previously commented[1] on my disappointment, obviously shared by others, that the promise of competition, including lower prices, never materialized. I have previously urged that an investigation be conducted to connect the dots between the proposed 59% rate increase, Pepco's swelling profits (including an increase in dividend to shareholders announced just days before the announcement of the rate increase) and the lack of competition[2]. But to address this serious problem, the State of Delaware must do more.

As a starting point, it will be important for the PSC to give the public a sense of whether it believes the increase[3] in pricing of electricity is a short-term condition (for example, the impact of Hurricane Katrina on natural gas prices) or a long-term issue reflecting, in part, flaws with deregulation. I believe, in fact, that there may well be two long term issues – these flaws in deregulation and the fact that oil and gas prices may not be coming back down.

The answer to this question is critical because different policies will be needed to deal with short- or long-term conditions, and with regulatory as opposed to resource-price issues. Regardless of what problems may be caused or exacerbated by improper regulation or de-regulation, the best way to deal with short-term price-increases may well be conservation and efficiency programs, as well as identifying programs that can provide additional assistance to the poor and small businesses; longer-term increases in the costs of current energy sources may require initiatives to facilitate the development of alternative energy supplies (including renewable energy sources). Moreover, if the pricing problem is a short-term problem, then addressing the issue through stiff re-regulation may actually exacerbate the lack of competition and may stifle the type of additional investment in generation capacity we should seek.

On the other hand, to the extent that the increases are more likely longer-term and if there seems to be little movement toward investments in additional generation capacity and ultimately lower prices, then there seems to be little compelling rationale for Delaware to stay with its deregulated regime. In that case, we would need to devise a system that provides reliable electricity at low prices while providing the type of regulatory environment where investment in generation infrastructure would be attractive. I lay out some ways to start thinking about such a system in this letter, although considerably more analysis is required.

To whatever extent the problem is the state's current deregulation policy, however, it's clear that three strong initiatives are presently warranted: (1) initiatives to create Delaware-generated alternative/renewable energy sources; (2) conservation measures; and (3) the identification of programs to assist those who need it most.

Facilitating the Development of Renewable Energy Sources: The development of alternative energy sources, including renewable energy, will be an important vehicle for ratepayers to minimize their reliance on the current power suppliers. This is also important because Delaware has little resident natural resources for energy production, so we are a net energy importer. We should develop a new Energy Plan that includes the Delaware-based development of energy (including, for example, wind resources, solar and biomass). A few other states, such as Texas and California, have been successful in carefully crafting regulatory rules and incentives to attract the major wind power developers and enable them to install significant capacity. Understanding that renewable energies are still often more expensive than traditional types of electricity generation, it would be of value for the PSC to make recommendations about tax incentives and other utility-based programs that could be put in place to encourage the development of renewable energy sources. I understand, for example, that some utilities allow customers to designate that some portion of their energy actually come from renewable sources, even if there is a surcharge for the customer.

In addition, it would be helpful for the PSC to assess whether Delaware's regulations (or PJM rules) in any way create barriers to the development of alternative and renewable energy sources. In some states, there are fees, stand-by charges, extra transmission charges and other barriers to renewable energy sources. In some cases, because these sources of energy depend on nature (like sun or wind), they are deemed to be unreliable and as a result certain stand-by charges and penalties (including penalties for power deliveries that vary from scheduled amounts) are imposed, thereby driving up the costs of these forms of electricity generation, making them less competitive. It would be helpful to know whether any of these issues apply in Delaware (including through any PJM rules). It would also be helpful to know whether there is a difference in tax treatment in Delaware for conventional power generation, as compared to renewable energy sources.

Promoting Conservation: Customers should have the ability to save real money by instituting serious conservation (demand management) initiatives. Some specific ideas include the following[4]:

- Implement a reward program for conservation efforts by residential and potentially business customers. An example could include a 20/20 reward structure, as has been implemented elsewhere, whereby consumers who reduce their energy use by 20% in a given month, as compared to the same month in the previous year, receive a 20% credit on their bill. Can the PSC provide some estimates of the potential benefits and costs of such a program in Delaware?
- Reduce energy use in major state buildings by 20 % compared to the previous year and challenge counties and municipalities and other public bodies to do the same. This would build on initiatives the Governor has previously taken, including those announced in October, 2005.

- Build on the Governor's encouragement of the use of Energy Star appliances by directing utilities to provide rebates to consumers who buy them. These appliances tend to be more costly than others, so many consumers tend not to make these investments. However, energy savings, over a long period of time, can make these good investments and up-front rebates will encourage consumers to make these purchases.
- Implement "time of day" charges so that customers can benefit from lower prices by using their electricity at off-peak times. It would be helpful for the PSC to explain the constraints which have limited the use of time of day charges to date.
- Improve energy efficiency building standards. The main tweaks to the building codes in other states have involved tightening the duct work in buildings (where lots of air conditioning and heat escape, causing inefficiencies) and reducing the amount of solar heat that radiates into the home through the attic and windows.
- Implement a massive public education campaign. The idea simply is to educate consumers about energy conservation and efficiency and to arm them with simple things that they can do to reduce their energy bills. It will be increasingly important for members of the public to understand exactly how much they end up paying for items like leaving the lights on, running their dishwasher and washing machine and the like. Currently, there is little of this type of price transparency when it comes to residential electric usage. For any public education program to work, it has to be very public and repeated tirelessly until it is effective.

Helping those who need it most*:* Of course, Delawareans have benefited significantly over the last several years with no increase in Delmarva's customer rates (notwithstanding these caps, Pepco Holdings has experienced excellent financial performance in recent years). Now, customers are expected to pay huge increases as these caps come off, but the question is raised: What happens to those who can't afford significantly higher prices, like hospitals, school districts, non-profits whose budgets are being cut by the federal budget; small businesses; and those with low incomes? The average amount collected per bill for low-income programs (like LIHEAP) in Delaware is only 10% of New Jersey's and 20% of Maryland's. It would be helpful for the PSC to provide some estimates of what it would take in aggregate dollars to ensure that those who need it most can take care of their basic utility needs. That analysis should also reflect the fact that the best way to help low-income residents in the long-term may well be to target investments in energy efficiency, so the government can minimize the extent to which it is paying for utility bills.

The areas addressed above – development of alternative energy sources, conservation and helping those who need it most – need to be addressed whatever the reason for the underlying problem that led to the huge increase in rates.

Beyond these fixes, however, the state must begin to consider the nature of longer term changes to our regulatory structure should the factors that led to the huge increase in rates not be quickly mitigated.

Imposing Limits on Rate Increases: One area that should be considered is related to the imposition of limits that would link future rate increases to the increase in cost of the underlying inputs.

Increased Transparency: One aspect of this reform would be the mandating of transparency in the bidding process, so that consumers can have confidence that the bids themselves are credible. I believe it will be of real value for the PSC to publicize both the names and prices of the winning bidders as well as the nature of the energy sources (that is, nuclear, coal, oil, natural gas, etc.). While I understand that the bidders[5] are hesitant to have their bids made public for competitive reasons, the public's right to know should come first (particularly related to finding out the extent to which Pepco Holdings' Delaware utility Delmarva Power[6] is relying on its unregulated subsidiary, Conectiv Energy, to generate power supply for Delaware customers).

Marginal vs. Clearing Pricing: Beyond transparency in bidding, the PSC should consider the advantages and disadvantages of ensuring that rates are allowed to rise only to a level consistent with the increase in input costs and not to the "clearing price." One of the major changes initiated by deregulation is that, even the lowest cost producers are paid the much higher "clearing price," that is, the price paid to the very highest cost producer that is needed to provide even one megawatt at a given time. In 2004 in Delaware, 34% of power generation was from natural gas (which is very high cost and whose price has increased much faster than coal), but 100% of the power generation has been paid for at the "clearing price" typically set by the least efficient natural gas power plant that is online at a given time. As a result of this change, producers of low cost power are reaping huge financial returns.

I understand that some people have represented that fixing this "clearing price" mechanism is dangerous because it would discourage the construction of additional generating facilities. However, others argue that fundamental financing and institutional constraints make it highly unlikely that unregulated generators will construct new facilities notwithstanding even more economic incentives including PJM's proposal to the Federal Energy Regulatory Commission for a large "Reliability Pricing Model" capacity surcharge that would raise customer rates for Delawareans even further. And in any case, the next proposal addresses incentives for generators.

Guaranteeing a Return on Investment for Power Generators: Should the state decide to limit the extent to which rates can be increased as outlined above (or through some other mechanism), it must recognize the trade-off it is imposing on suppliers[7]. Profit potential (and risks) would be mitigated, so utilities should be entitled to some guarantee on investment in order to provide for a return to shareholders and for reinvestment in infrastructure.

Certainly, there may be a large number of options to consider when it comes to dealing with the long-term goal of providing for reliable power at affordable prices in a way that is profitable for the power companies. Negotiating among these options will require the best possible alignment of interests among the major players as much as possible. The players are: a) residential customers, b) small and mid-sized business customers, c) Pepco Holdings shareholders, and d) power suppliers aside from Pepco's Conectiv Energy. Obviously, these entities have many goals which may conflict with each other. But all parties probably recognize that the current situation (i.e. significant fluctuation in electricity costs and the existence of an unregulated monopoly) is not sustainable. Furthermore, there seem to be a number of shared goals:

- Keep the lights on
- Attain a diversified set of potential power suppliers

- Predictability in pricing (as low as possible) and in the earnings stream for Pepco Holdings shareholders

I am hopeful that the parties will be brought together to negotiate a solution which is in the best interests of Delawareans and which will deliver reliable power at affordable and predictable prices. I also hope that this negotiation will be as transparent as possible, including opportunities for public input so that Delawareans have a meaningful chance to contribute to the dialogue.

Please let me know if I can provide clarification on any of these questions or suggestions. I look forward to your response to this letter.

Sincerely,

Jack Markell

Jack Markell
Delaware State Treasurer

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[1] My previous comments were made on February 9.

[2] It will be important to get the PSC's guidance about why the competition that was supposed to have developed, keeping prices low, never materialized.

[3] The proposed 59% increase represents approximately $150 million in higher rates annually for residential customers, $8 million for small commercial customers, $56 million for mid-sized commercial customers, $35 million for large commercial customers and $173 million for a variety of other customers, including landlords, state office buildings and the like. As has been discussed at considerable length, Delawareans are stretched by cost increases in a number of areas and these utility charges are particularly burdensome. Governor Minner has already charged the PSC with examining the feasibility of deferring or phasing in the proposed increases. Others, including me, have made similar recommendations. Similarly, Governor Minner charged the PSC with examining the feasibility of requiring Delmarva to enter into long term supply contracts. In my comments on February 9, I also mentioned the potential value of having Delmarva enter into such contracts.

[4] It would be helpful for the PSC to address which of these programs have already been implemented in Delaware

[5] During December and January, the Public Service Commission took bids on generated power for the standard offer market price. Eleven bidders competed. Several bidders won (bidders actually bid on a variety of different customer classes and time of use categories) and the lowest winning bid across all categories is 59%. I understand that the Public Service Commission will shortly be releasing the names of the winning bidders.

[6] Prior to deregulation, Delmarva Power owned generation facilities. After deregulation, Delmarva sold its generating capacity (i.e. Indian River plant and ownership interest in nuclear facilities at Salem and Oyster Creek). It will be important for the PSC to quantify the impact of Delmarva's decision to sell off its relatively low cost generating facilities and whether or not the proposed rate increase is higher than it might have been had those facilities not been sold. As part of this analysis, the PSC could provide additional helpful information by quantifying all of the components of the proposed 59% rate increase (the actual price increases of the inputs vs. the disposition of low cost generating facilities vs. the change from marginal pricing to "clearing price").

[7] Before deregulation, suppliers were able to recover their investment in generating assets with a guaranteed return. That guarantee is no longer in place – and as a result, financial results are far more likely to fluctuate significantly for power suppliers like Conectiv Energy (hence a significant financial risk for its parent Pepco Holdings). At a time when the marginal cost of the highest cost producer is high (as today), the low cost suppliers do very well. If margins get squeezed and prices come down, power suppliers have no guaranteed return (as they had before deregulation).